GCM GROSVENOR

Diverse Manager Investing: Shining a Light on Potential Blind Spots

Introduction

Institutional investors are increasingly sending a positive message to asset managers about the need for diversity. They are expanding their networks to seek the best ideas, people, and opportunities, and putting capital to work, thus overcoming the common misconception that investing in diverse managers means sacrificing returns. In doing so, they are taking into account recent studies that show diverse teams make better decisions and diverse managers have outperformed their non-diverse counterparts.

While investors focus on metrics that matter, managers are compelled to institutionalize their investment approach and organizational policies/practices regarding diversity. A recent study completed by ILPA found that 59% of investors collect Diversity, Equity, and Inclusion (DEI) metrics from their managers, with 22% of investors stating that a manager's progress on DEI will be considered as a due diligence factor when determining investing in future funds.

But with positive data and increased attention on diversity, the question remains: why aren't more dollars going to diverse managers? We are finding that, as LPs integrate diversity into their investment programs and into their firms, they are faced with a set of new challenges, or "blind spots." Here, we shine some light on these blind spots.

Past performance is not necessarily indicative of future results. No assurance can be given that any investment will achieve its given objectives or avoid losses. Unless apparent from context, all statements herein represent GCM Grosvenor's opinion.

Strong performance, but allocations are still lagging

Diverse managers outperformed their equivalent benchmark in 83% of periods measured...[1]

...but diverse-owned firms represent just 1.4% of U.S.-based AUM[2]

1 National Association of Investment Companies, "Examining the Returns," 2021. MOIC of diverse managers represented by the NAIC Private Equity Index, measured against the median Burgiss private equity fund.
2 Knight Foundation, "Knight Diversity of Asset Managers Research Series: Industry," December 2021.

Blind Spot 1: What Do You Mean, "Diverse?"

Surprisingly (or perhaps not), how organizations define "diverse manager" can be a gating factor against getting their portfolio programs launched, and for managers to get their funds raised. Too often, experienced GPs that have proven their ability to deliver results may be excluded from a search based on definition alone. In some cases, a manager can spend much time and effort pursuing an allocation only to find out late in the process that they do not meet the investor's diversity requirements.

There are many classifications of diverse groups: ethnic diversity, gender, veteran status, or others. When these are matrixed against organizational factors like ownership, board composition, decision-making/management, portfolio management, or tenure, things quickly become very complex.

There is no standard definition for what makes a manager diverse. U.S. public pension plans, for example, may have very different definitions for diverse managers based on regional, political, or social factors. Meanwhile, some organizations may consider a manager diverse only if 50% of ownership are Black/African-American – while a firm of similar size and makeup might use a broad definition to include a range of ethnic diversities, women, and LGBTQ individuals.

Bridging the gap

Because there is no one-size-fits-all approach, many forward-thinking LPs are taking steps to educate managers on how they define diversity in their investment programs. The goal: provide managers with the information they need to be more focused in their fundraising efforts, more communicative in how they identify as diverse, and more knowledgeable about what investors are seeking.

In addition, certain LPs are advocating for the industry and helping determine common ground by partnering with organizations like ILPA and its Diversity in Action program. By participating in programs like these, organizations not only commit to their own diversity goals, but they also act as an information bridge to share LPs' criteria on diversity while enabling GPs to learn and adapt to those criteria.

Other organizations contributed to the industry early-on, helping create DEI principles and standards. For example, the Diverse Asset Managers Initiative (DAMI) produced the **Fiduciary Guide to Investing with Diverse Asset Managers and Firms** to help interested LPs navigate the steps to investing.

Where are the women?

There is still room for improvement in gender diversity. This, despite a recent study that suggests the performance of gender-balanced investment teams is correlated with higher returns. The research found that funds with gender-balanced senior investment teams realized net IRRs 20% greater than male- or female-dominated funds when controlling for vintage, geography, and strategy. Similarly, portfolio companies with gender-balanced leadership teams demonstrated 20% higher increases in valuations.[3]

67%
of **GPs** said gender balance is important, but..

65%
of **LPs** consider gender diversity important, but..

10%
have strategies to improve promotion rate of female employees

25%
ask about it in the diligence process

This data was gathered in 2019, right before the pandemic, and we have already seen improvement. As mentioned, more organizations are adding gender/diversity related questions to their diligence questionnaires, while industry organizations are better defining the standards.

In addition, imbalanced gender diversity can be a self-perpetuating cycle because referrals and professional networks are the most common ways of sourcing new talent. Fortunately, an increasing number of firms are seeking to break this cycle through their practices of hiring, retention, and promotion of female employees.

Many organizations (including GCM Grosvenor) abide by formal diversity, equity, and inclusion policies that guide their commitment to opportunities for women and other traditionally underrepresented groups. These firms have expanded their recruiting networks to source from a more diverse talent pool (and remove potential biases from the process), while increasing training, and expanding employee resource groups.

3 Source of data in first paragraph and graphic: International Finance Corporation, Oliver Wyman, and RockCreek (2019). "Moving Toward Gender Balance in Private Equity and Venture Capital." **https://www.ifc.org/wps/wcm/connect/79e641c9-824f-4bd8-9f1c-00579862fed3/Moving+Toward+Gender+Balance+Final_3_22.pdf?MOD=AJPERES&CVID=mCBJFra**

Blind Spot 2: Due Diligence Differences

Many diverse managers are first-time firms and, like many emerging managers, can have imperfect track records, minimal non-investment infrastructure, and/or teams working together for the first time. In these cases, LPs may lack the resources and expertise to properly diligence certain aspects inherent to diverse and emerging managers.

Thus, there may be an unintended bias against diverse managers in many institutional LP's due diligence processes. In addition, many firms over-rely on initial screens and questionnaires within their diligence process that end up being too binary or "check box" in nature, and may unintentionally eliminate a diverse manager based on factors that are not pertinent to the manager's strategy or reasonably within its operating budget yet.

Fortunately, more LPs are approaching the evaluation of diverse and emerging managers with more of a customized, "hands-on" approach whereby the specific facts and circumstances of a manager's status – both current and where they want to be – are considered without materially impacting the underwriting standards. Proper investment due diligence combined with a robust, yet flexible approach to operational due diligence (ODD) is essential when assessing a diverse or emerging manager's suitability for managing institutional capital.

In many cases, institutional LPs also provide significant assistance and consulting/advice during the diligence process with the goal of partnering alongside the manager to help build their investment infrastructure and non-investment operations. By doing so, these LPs are still properly performing the necessary due diligence while providing more opportunities and access to capital. At GCM Grosvenor, we share this view and apply the same nuanced approach on behalf of our clients.

Blind Spot 3: GP Commit Can Create a Misalignment of Interests

Expectations of GP commit – the amount of capital a manager is expected to bring to the table – can sometimes create difficulty for diverse managers during fundraising. Because of their "traditional" models, some institutional investors may place an undue burden on a diverse or early-stage manager. By taking a similar approach as they would with a multi-billion-dollar buyout fund, LPs are not aligning their interests with those of a diverse manager.

Starting a firm requires a lot of working capital, and it takes much longer than ever to raise a fund. LPs do not want to put a GP at a disadvantage right from the start but, when combined with a manager's operational costs, fundraising, and other expenses, traditional GP commit approaches can do just that.

We believe a better approach is to reframe expectations to be more realistic on what a GP can contribute.

The move toward better data

Organizations like ILPA and the Principles for Responsible Investment (PRI) are enhancing metrics and revising due diligence questionnaires, with DEI and ESG topics more focused on data transparency.

The updated questionnaires are intended to have more globally relevant designations for race and ethnicity and more inclusive information on gender/diversity. They also survey a manager's willingness to require and implement DEI policies, code of ethics, and hiring practices.

For example, updated questions include:

1. Does the firm disclose U.S. Equal Employment Opportunity Commissions (EEOC) EEO-1 form?
2. Does the firm track and report data on race, ethnicity, gender, including additional categories of diversity, LGPTQA and disability status?
3. How frequently does the firm revise the DEI policy or initiatives?

One idea is to consider the manager's net worth and assess the appropriate percentage of their GP commit by aligning interests without breaking the financial stability of the new manager. That would reframe the "right" number. Additionally, some managers fund their GP commit through an offset from either management fees or distributions.

Looking forward

At GCM Grosvenor, we share the goals of our industry partners: create a common language of diversity, standardize KPIs, identify policies and strategies that work, define the future of reporting, and always seek to generate strong performance as fiduciaries of capital. In doing so, we aim to create and/or support sustainable frameworks that will better facilitate allocations to managers that have traditionally been underrepresented.

To get there, we continue to listen to clients to better ensure our investments and the managers with whom we invest are meeting their criteria. We support managers and discuss with them how to avoid blind spots. We are also advocating on behalf of LPs and diverse GPs to actively help move the industry forward by hosting events like **Consortium** – our diverse and women manager conference – being a signatory to the PRI, and participating on ILPA's Diversity in Action program.

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